

No. 15,174

IN THE

United States Court of Appeals
For the Ninth Circuit

AMERICAN PIPE & STEEL CORPORATION,
Petitioner,

VS.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITIONER'S REPLY BRIEF.

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PETITIONER'S REPLY BRIEF.

PRELIMINARY STATEMENT.

- I. PETITIONER ESTABLISHED THAT LEGITIMATE BUSINESS PURPOSES, NOT TAX AVOIDANCE, MOTIVATED ITS ACQUISITION OF PALOS VERDES.

Briefly stated, in 1942 one Archer started to acquire the capital stock of Palos Verdes Estates, Inc. (referred to as Palos Verdes) with the plan of interesting investors in advancing funds for the payment of back taxes on attractive residential lots owned by Palos Verdes in exchange for an interest in the company. Archer was acting for himself because the lots had tremendous potential value. He was unable to obtain financing, however, and on November 25, 1943, petitioner took action to acquire the Palos Verdes stock for itself for business reasons. On December 2, 1943, petitioner acquired all the stock of Palos Verdes then outstanding, and thereafter petitioner utilized Palos Verdes as a profitable and effective subsidiary. Based upon its acquisition and ownership of

the Palos Verdes stock, petitioner filed consolidated income tax returns in 1944, 1945 and 1946.

Respondent Commissioner made a determination that on or about December 2, 1943, petitioner acquired all of the capital stock of Palos Verdes, that such acquisition was for the principal purpose of avoidance of Federal income and excess profits taxes by securing the benefit of deductions, credits or other allowances of Palos Verdes which petitioner would not otherwise enjoy. (Tr. pp. 30-31.)

A petition for redetermination of deficiencies was duly filed in the Tax Court and, in support thereof, petitioner proved that legitimate business reasons, not tax avoidance, motivated its acquisition of Palos Verdes. Specifically, petitioner proved the following:

A. *Legitimate business purposes motivated its acquisition of Palos Verdes.*

1. Petitioner's business purposes in acquiring Palos Verdes were set forth in its corporate action duly taken. (The evidence is set forth in our opening brief, pp. 7-12.)

2. On the same day Palos Verdes was acquired, petitioner's president worked out a program for the profitable sale of lots. (Op. Br., pp. 13-14.)

B. *The utilization of Palos Verdes by petitioner as a profitable subsidiary confirms the business purpose of its acquisition.*

1. Petitioner almost immediately realized a profit of 33% on its investment by sales of Palos Verdes lots. (Op. Br., pp. 14-15.)

2. Petitioner caused Palos Verdes to replace its lots with other properties calculated to afford petitioner the same outlet for its products and for expansion of its activities. (Op. Br., pp. 15-19.)

3. In furtherance of petitioner's plans for expansion of its oil well equipment business, Palos Verdes acquired profitable oil leases. (Op. Br., pp. 19-20.)

4. Palos Verdes also leased and operated an oil refinery in order to effectuate petitioner's plans for expansion of its oil equipment business. (Op. Br. pp. 20-21.)

5. In addition, petitioner's oil equipment business was promoted by Palos Verdes' acquisition of a boat for charter to oil companies engaged in geological work off the Coast. (Op. Br., pp. 21-22.)

6. Acquisition of Palos Verdes provided a highly profitable outlet for disposal of Chemical Warfare containers when the original plan for their use could not be carried out. (Op. Br., pp. 22-24.)

C. *Experience has demonstrated the good faith and sound judgment of petitioner in making its decision to acquire the Palos Verdes lots. The tremendous potential value of such lots has been realized. (The evidence is summarized at pages 24-25 of our opening brief.)*

D. *Petitioner established that it had no motive whatever for the acquisition of Palos Verdes as a "tax loss" corporation, in that petitioner had no large past, present or prospective profits or high earning assets. (Op. Br., pp. 26-28.)*

II. RESPONDENT MADE NO EFFORT TO REBUT THE CASE ESTABLISHED BY PETITIONER, BUT THE SMEAR TECHNIQUE WAS EFFECTIVELY USED IN THE TAX COURT.

At the outset of the trial, respondent seemingly realized that he could not produce any evidence of predominate tax avoidance motives on the part of petitioner as charged in the deficiency notice. To overcome his lack of evidence, respondent sought to create an atmosphere of suspicion by making baseless charges and insinuations concerning matters wholly unconnected to the issue of petitioner's purpose in acquiring the stock of Palos Verdes. This technique was typified by the inflammatory opening statement made by respondent's counsel. The following are examples of the unfounded and illogical accusations so made:

"Now, in this escrow arrangement that was opened in August of 1943, Mr. Archer appears as nominee. He never represented himself, the facts will show, as anything other than a nominee, not a principal, but an agent." (Tr. pp. 107-108.)

"The evidence will show . . . that Mr. Archer . . . when he ran upon a shareholder who was unduly suspicious of his motives, represented to them that he represented a defense plant engaged in war contracts, and that the only reason why his principal was interested in this stock was in order to broaden its tax base under consolidation of operations." (Tr. pp. 108-109.)

These charges were baseless. As we have pointed out (Op. Br., p. 49), respondent made no serious effort to rebut the case established by petitioner and he certainly failed to produce any evidence of accusations such as those quoted.

The fact is that the escrow was opened and maintained by Archer individually (Tr. pp. 636-641; Exs. 51, 52, 53) and he never acted for anyone else in connection therewith. (Tr. pp. 146, 175, 214, 232.) Neither did he attempt to resell the Palos Verdes stock to a defense plant as that of a tax loss corporation. (Tr. pp. 178, 181, 182.)

More important, respondent made no effort to show how these charges, even if true, could have any bearing on the ultimate issue in the case, namely, petitioner's purpose in acquiring the Palos Verdes stock.

Respondent succeeded admirably, however, in creating a vague impression that somebody had some sinister motive of some kind at some point. Indeed, respondent's technique succeeded so well that, at the beginning of the testimony of petitioner's president, the trial judge remarked (Tr. p. 337):

"The Court. I have already formed my impression of Mr. Lane, before he took the stand."

III. RESPONDENT FAILS TO MEET PETITIONER'S ARGUMENTS. INSTEAD, HE ATTEMPTS TO CREATE A VAGUELY SUSPICIOUS ATMOSPHERE BASED UPON TWISTED FACTS.

Respondent makes no effort to meet the points argued in our opening brief. The documentary evidence shows that petitioner's business purposes in acquiring Palos Verdes were set forth in its corporate action duly taken and respondent cannot deny it. (Pet. Op. Br., pp. 7-12.) The documentary evidence further shows that on the same day Palos Verdes was acquired, petitioner's president worked out a program for the profitable sale of its lots

(Pet. Op. Br., pp. 13-14), a fact which respondent neglects to mention. The undisputed evidence was that, upon acquisition of Palos Verdes, petitioner utilized it as a profitable subsidiary in numerous ways (Pet. Op. Br., pp. 14-24), but that evidence is largely omitted from the findings of fact and is entirely disregarded in respondent's brief.

It was established without contradiction that the Palos Verdes lots had great value and that such value had been proved by subsequent experience. (Pet. Op. Br., pp. 24-25.) Respondent cannot meet this evidence so he ignores it.

The overwhelming factor which respondent cannot answer is that petitioner had no tax motive whatever in the acquisition of Palos Verdes because petitioner's financial position was extremely poor. Respondent seeks to overcome this factor by misrepresenting the evidence relative to petitioner's financial condition or, failing in that approach, by arguing, in the face of his own deficiency notice and of uncontradicted evidence to the contrary, that Archer was acquiring the stock for petitioner when its profit prospects were better.

In substance, respondent seeks to create the same atmosphere of vague suspicion in this Court by methods similar to those used in the Tax Court, particularly by (a) the use of contemptuous epithets in referring to uncontradicted evidence, (b) twisting the facts so that they may appear in what is supposed to be a vaguely sinister light, and (c) misrepresentations of the evidence.

In addition, respondent attempts to sustain the decision of the Tax Court by undertaking a complete change

of position. He argues that petitioner was not entitled to file consolidated tax returns regardless of Section 129 of the Internal Revenue Code (Resp. Br., p. 39) and that his determination may be upheld as a distribution or allocation of gross income, deductions or credits under Section 45 of the Code (Brief, p. 45). This contention is made notwithstanding the fact that the deficiency notice did not specify any such grounds (Tr. pp. 30-31), the decision under review was based solely on Section 129 (Tr. pp. 75-79) and the position argued by respondent in the Tax Court was just the opposite. (Tr. pp. 110-111.)

The mechanics of respondent's technique are further analyzed below.

A. Respondent misrepresents petitioner's profit picture. The fact is that petitioner had no large past, present or prospective profits.

1. Petitioner was in a precarious financial condition as a result of the termination of the chemical warfare contract.

Flagrant misstatements made by respondent are that on December 2, 1943, when petitioner acquired Palos Verdes, "no loss on the chemical warfare contract could have been anticipated" and that "American Pipe's financial outlook was bright" at that time. (Resp. Brief, pp. 31, 33.)

The fact is that in the latter part of 1943 petitioner was facing a huge loss as the result of the contract termination. The only testimony on that issue was by Mr. Lane. He stated that the loss was originally estimated at \$350,000 to \$400,000, that, when the amount of petitioner's claim was subsequently determined, the loss was estimated at over \$600,000, and that the final settle-

ment of the claim did not occur until the last week in December. (Tr. pp. 373-375.) The first indication was that the Government would pay only \$600,000 on the claim and later indications were that \$800,000 was the top figure. (Tr. p. 373.)

Petitioner's outstanding loan, necessitated by the contract, was \$1,020,070.82; in addition, petitioner had an actual cash investment in the contract over and above the borrowed funds in the amount of \$368,970.31; further, petitioner's accounts receivable had been assigned to the bank under the requirements of the loan, and the cancellation of the contract left petitioner without operating funds. (Tr. pp. 427-429.) The final settlement resulted in a loss of \$116,240.30 to petitioner; that loss was reported on petitioner's income tax returns of 1943 and cannot be questioned. (Jt. Ex. 40-C.) Petitioner's net income for 1943 was a meager \$16,880.52. (Tr. p. 52.)

Contrasted with respondent's assertions, therefore, the fact is that petitioner's financial position in December, 1943, was extremely bleak. In fact, it bordered on the disastrous.

2. Petitioner was a small company with a history of losses and small profits and no immediate prospects of anything better.

With an utter disregard for the facts established by the evidence, respondent asserts that petitioner "had substantial earnings from war contracts", that it had "war profits", that in 1942 petitioner's "prospective earnings picture was very encouraging", that "This Court may take judicial notice that American Pipe was certain to obtain war contracts", that "there was every reason to

believe that other contracts would quickly fill the place of the chemical warfare contract", that "the Tax Court could well infer that additional defense contracts would quickly fill the temporary gap, as indeed they did" and that petitioner was "certain" to have "huge profits." (Resp. Brief, pp. 26, 32, 33.)

The fact is that petitioner could hardly be compared with General Motors. It had no large past, present or prospective profits on December 2, 1943, when Palos Verdes was acquired, nor did it have any high earning assets. Petitioner:

"was a small company. And they had had a record of losing money for a number of years, back to 1929, ten or eleven or twelve years." (Tr. p. 338.)

The fact is that petitioner had net profits of only \$2,416.33 in 1940, \$54,633.62 in 1941 and \$48,101.11 in 1942. (Jt. Ex. 40-C; Tr. p. 482.)

The fact is that petitioner had never had any substantial war contracts other than the chemical warfare contract. (Tr. pp. 352-353.) The largest such contract awarded to petitioner in 1943 amounted to only \$32,369.76. (Ex. 31.)

The fact is that, upon termination of the chemical warfare contract in 1943, petitioner was faced with a huge loss, a loss originally estimated at \$350,000 to \$400,000, subsequently estimated at \$600,000 (Tr. pp. 373-374), and finally fixed at \$116,240.30. (Jt. Ex. 40-C.) The fact is that petitioner's accounts receivable were pledged to the bank under the terms of a loan exceeding a million dollars, and petitioner was without operating funds. (Tr. pp. 428-429.)

The fact is that the total backlog of war contracts which petitioner had outstanding on December 31, 1943, was the trivial amount of \$850. (Ex. 31.)

The fact is that petitioner did not receive any further war contracts of any size until the latter part of 1944. (Ex. 44.)

Finally, the fact is that the Tax Court did not infer that "additional defense contracts would quickly fill the temporary gap". In conformity with the uncontradicted evidence, the Tax Court found only that substantially all of the war contracts subsequently awarded to petitioner were awarded on or after July 15, 1944, and that the largest contract awarded prior to May 12, 1944, was for \$1,800. (Tr. p. 75.)

It is absolutely essential to respondent's position that he ignore the foregoing facts since they are completely inconsistent with his determination. In substance, there was nothing in petitioner's past, present or foreseeable future on December 2, 1943, which presented any particular problem with respect to income or excess profits taxes.

B. There was nothing fictitious about the losses reported on Palos Verdes' tax returns.

The fact that Palos Verdes actually sustained the losses in the amounts reported on its tax returns was first questioned by respondent (Tr. pp. 47-48) and then conceded, in that the issue was abandoned by respondent. (Stipulation, paragraph 16; Tr. pp. 51, 111-112.) Nevertheless, in pursuance of his smear tactics, respondent persists in referring to such losses as "fabricated losses" and "huge paper losses." (Resp. Brief, pp. 26, 41.) His

brief is permeated with similar efforts to dismiss uncontradicted evidence and conceded facts with such smears.

C. The alleged agency of Archer is a false issue.

Apparently sensing the futility of his attempt to misstate petitioner's profit picture in December, 1943, respondent asserts that petitioner actually obtained a majority of the Palos Verdes stock at an indefinite earlier date through the services of Archer. (Resp. Brief, pp. 28, 29, 30, 31.) This is but another aspect of respondent's smear technique because (1) the deficiency notice was not based upon any such acquisition, (2) the alleged agency of Archer has no bearing on the case, (3) there was no evidence of any such agency, and (4) no such agency was found.

1. Respondent is contradicted by his own deficiency notice.

Respondent's notice of deficiency was not based upon any supposed acquisition of the Palos Verdes stock, through Archer or otherwise, in 1942 or at any time in 1943 before December 2nd. It was based solely upon the theory that petitioner made the acquisition "on or about December 2, 1943," for the principal purpose of avoiding taxes (Tr. pp. 30-31) and it was this determination which the Tax Court "affirmed." (Resp. Brief, p. 18.) Respondent cannot sustain his determination on a different theory. (*Commissioner v. Chelsea Products, Inc.* (1952, 3rd Cir.), 197 F.2d 620, 624.)

2. The alleged agency is immaterial.

Very little effort is made by respondent to show how any supposed agency has any materiality here. Indeed,

he concedes that such fact would "make very little difference." (Resp. Brief, p. 33.) The point is raised largely for its supposed effect of creating a vague impression of something sinister. The fact is that this case could not involve any secret agency or concealed income or other question of tax evasion. It involves, instead, the acquisition and ownership of a subsidiary, openly proclaimed and asserted. The acquisition and ownership must be open because that is the very basis of the consolidated tax returns filed by petitioner.

3. There was no evidence of such agency.

Archer testified that he was acting for himself and not as anyone's agent. (Tr. pp. 146, 175, 214, 232.) The documentary evidence confirmed his testimony. (Tr. pp. 639-641.) It was further shown that, by letter of May 25, 1943, Archer unsuccessfully attempted to interest petitioner in investing in the Palos Verdes project. (Ex. 6; Tr. pp. 161-162.) The letter was not impeached or questioned.

Respondent, however, seeks some comfort in the fact that the offer to stockholders, mimeographed by Haggott (Tr. p. 214), referred to "R. P. Archer, Nominee." (Resp. Brief, p. 29.) But no effort is made to show how any such representation by Haggott or even by Archer, without the knowledge of petitioner, could be binding upon petitioner or could even relate to petitioner.

It is also contended that Archer paid a "premium price" for the Palos Verdes stock and that this shows that "American Pipe would be willing to pay a premium for the tax losses it was purchasing." (Brief pp. 33, 39.)

The logic of this argument is wholly unsound. Even if Archer had paid a “premium price”, how could that tend to prove predominating tax motives on the part of petitioner? Moreover, it is absurd to characterize \$2 a share as a “premium price” for any stock. Finally, there was no showing that Archer or any other person could have acquired the stock for any less price. The so-called market price merely reflects what willing buyers, if any, would pay to willing sellers, if any, for such stock as may be put on the market. It does not show the price at which most or all of the stock could be acquired, including acquisitions from unwilling sellers. There was no indication that any substantial amount of the stock could have been purchased for anything less than \$2 a share. In fact, it required a period of eight months to a year for Archer to purchase only about two-thirds of the stock even at that “premium price” and it was a “slow process.” (Tr. p. 158.)

Respondent asserts that “Archer knew that 51 per cent of the stock was a controlling interest, and had no explanation of why he insisted on 100 per cent” (Resp. Brief, p. 8) and that he turned the Palos Verdes stock over to petitioner in consideration of the cancellation of his indebtedness when he “suddenly realized that he could not raise the money to pay the taxes.” (Brief, p. 30.)

The fact is that Archer never undertook to pay the back property taxes himself. His plan was to interest investors in the Palos Verdes project (Tr. pp. 186-188) and that is what he attempted to do. He discussed the matter with several potential investors, but they would

not commit themselves until he had control of the company and could make a concrete offer. (Tr. pp. 189-190, 231, 238, 262.) Archer even attempted to interest petitioner in investing in the project in May, 1943, but without success. (Ex. 6; Tr. pp. 161-162, 238.)

It was due to the necessity of bringing outside investors into the project that Archer needed more than 51% of the stock; he could not sell part of his interest and still retain control or any substantial part of Palos Verdes otherwise. He explained this fully in his testimony. (Tr. p. 237.)

Finally, respondent argues that "Ostensibly" Archer was hired to expedite the chemical warfare contract "after his sole contact of influence was seen to be useless", that "The record does not abound with descriptions of Archer's work as an expediter", that "His label as an expediter was a sham" and that, therefore, Archer must have been hired to acquire the Palos Verdes stock for petitioner. (Resp. Brief, pp. 27-28.)

This is a horrible example of respondent's technique of making unreasonable deductions from twisted facts. The fact is that Mr. Lane thought that he was going to get a chance at the chemical warfare contract, and it would mean considerable travel for him, although the awarding of the contract was by no means certain. (Tr. pp. 345, 359.) The fact is that Archer was hired by petitioner to assist Mr. Lane by expediting production and that is exactly what he did. The fact is that Archer testified at length as to work in controlling production, meeting schedules, obtaining materials, placing work with

subcontractors, getting work through inspections and obtaining priorities. (Tr. pp. 140-142.)

4. No such agency was found.

The decision of the Tax Court was not based upon any supposed secret agency or conspiracy as is suggested by respondent. The findings were in accordance generally with the uncontradicted evidence, that is, that all shares were acquired by Archer for himself up to November 25, 1943, when petitioner resolved to make the acquisition itself. (Tr. pp. 56, 57, 60.)

D. There was no "sudden liquidation" of Palos Verdes.

1. The sale to Dahlberg showed tax stupidity, not tax motives.

There was no mysterious "sudden liquidation" of Palos Verdes, as respondent suggests. (Brief, p. 35.) The terms of the interlocutory decree in the Palos Verdes tax suit provided that the property taxes had to be paid within six months after the decree became final; the normal period of redemption was not recognized. (Jt. Ex. 1-A.) Mr. Lane did not learn of the limited redemption period provided in the decree until after petitioner had acquired the Palos Verdes stock; he naturally assumed that the normal period of redemption would apply. (Tr. pp. 405-406, 492-493.) It was for that reason that he was willing to enter into the transaction with Dahlberg. (Tr. p. 406.) *Otherwise, the lots would have been lost for taxes anyway.* Lane had originally planned to pay off the property taxes in installments on the ten-year plan.¹ (Tr. p. 491.)

¹The ten-year installment plan was formerly set forth in the California Revenue and Taxation Code, secs. 4256-4263, repealed by Stats. 1955, ch. 381, p. 841, sec. 3; see West's Anno. Calif. Codes, Rev. and Tax. Code, pp. 656-657.

American Pipe's lawyer, who had prepared the decree" and the "fact finder would be warranted in finding it unbelievable that the lawyer who handled these transactions for American Pipe did not advise Lane of the critical terms of the decree." (Brief, p. 36.)

Respondent's sophistry is matched only by his twisting of the facts. The Tax Court found only that Mr. Dolley's clients included both petitioner and Palos Verdes; it did not find that Mr. Dolley "handled these transactions for American Pipe" or that he informed one client of the affairs of the other one. (Tr. p. 61.) The uncontradicted evidence was that Mr. Dolley was one of two attorneys employed by petitioner in 1942 and 1943 (Tr. p. 492), that he did not advise Mr. Lane of the terms of the decree (Tr. p. 492), that Mr. Dolley was hired by Archer to bring the tax suit on behalf of Palos Verdes (Tr. p. 205) and that Mr. Dolley had previously represented Archer in connection with his divorce action. (Tr. p. 206.) There was no evidence that Mr. Dolley had anything to do with petitioner's acquisition of Palos Verdes.

The mere fact that an attorney represents several clients does not charge each client with knowledge of all the affairs of the others, and especially not in the face of direct and uncontradicted evidence to the contrary.

4. Palos Verdes was utilized as a profitable subsidiary.

Respondent's "sudden liquidation" argument completely ignores the evidence as to petitioner's continued profitable utilization of Palos Verdes as a subsidiary. (Pet. Op. Br., pp. 14-24.)

E. The tremendous value of the Palos Verdes lots has been proved.

Respondent alleges that the old stockholders of Palos Verdes held the stock "as the land declined in value to almost worthlessness." (Brief, p. 43.) No transcript references are given for this assertion because it cannot be sustained by the record.

The fact is that the Palos Verdes lots had values far in excess of the amount of delinquent property taxes on them, but the company had been the victim of poor promotion. (Tr. pp. 130-131.) The lots had sold for more than \$500 each and some had been sold for as much as \$10,000 to \$15,000 a lot (Tr. p. 169), whereas the taxes amounted to less than \$150 per lot. (Tr. pp. 133-134.)

Subsequent events have demonstrated beyond any question that huge profits could be made on the development and sale of the Palos Verdes lots, just as Mr. Lane calculated on December 2, 1943. (Ex. 24; Tr. pp. 417-418.)

Of the some 300 lots now owned personally by Mr. Lane (Tr. pp. 454-456), he has been offered \$90,000 for 75 of them and \$150,000 for the remainder of the lots: those are wholesale prices offered by responsible real estate builders. (Tr. p. 456.) Mr. Towle, a real estate broker who had been in business in the Palos Verdes area since 1921 (Tr. pp. 530-531), testified that lots in that area were worth \$1,200 to \$2,250 by 1948 or 1949. (Tr. pp. 543-545.) Some lots there are now valued at \$3,500. (Tr. pp. 532, 546.) A house purchased for \$12,500 in 1942 was sold for \$47,500 in 1950 and is now offered for sale at \$65,000. (Tr. p. 550.) In 1954, an undeveloped tract of 73 lots in the Palos Verdes area was sold for \$110,000. (Tr. pp. 551-552.)

F. Petitioner's business purposes could not have been accomplished by organizing a new corporation.

The business reasons prompting petitioner's acquisition of Palos Verdes were set forth in Mr. Lane's letter of November 25, 1943, and were restated in his testimony at the trial. (Ex. 20; Tr. pp. 391-396.) As we have shown (Op. Br. pp. 14-24), petitioner actively utilized Palos Verdes as a profitable subsidiary. Respondent asserts, however, that "Lane admitted on cross-examination that the stated advantages would largely have been available to American Pipe by forming a new corporation." (Brief, pp. 12-13.)

Respondent is mistaken. Mr. Lane's testimony was only that acquisition of Palos Verdes was not *absolutely essential* to some of the purposes, though such acquisition was certainly more advantageous than forming a new company. He pointed out that, "if a person had the capital to go out and buy property, they could have organized their own corporation, but this corporation had 700 lots at \$10 a lot" (Tr. p. 501), that a profit of \$8 or \$10 a lot could be made on the sale of water pipe alone in Palos Verdes (Tr. p. 501) and that, with respect to expansion of petitioner's oil well supply business, "we could have organized another company but it would not have been as practical as having a company that already had those assets that you were buying for two cents on the dollar." (Tr. p. 503.)

Respondent's argument completely disregards the huge profits which could have been made on the development and sale of the lots but for the peculiar redemption terms of the decree in the tax suit.

G. Respondent misrepresents the reason why petitioner did not reacquire the Palos Verdes lots.

It is twice asserted that petitioner did not reacquire such lots at the 1947 tax sale because Mr. Lane's business associates felt that the real estate business was not germane to the steel business. (Rep. Brief, pp. 15, 37.)

These statements are directly contrary to the evidence. It was the agents of the Internal Revenue Service, not the business associates of Mr. Lane, who made that claim. After repeated objections to such evidence by respondent's counsel, the following occurred (Tr. p. 459):

“Q. . . . Mr. Lane, . . . will you state whether or not you or your associates were under the impression in 1947 by reason of the investigation . . . and audit that had been made by the Internal Revenue Service, that it would not be advisable for you to reacquire real estate in the name of American Pipe and Steel Corporation?”

“Mr. Chase. . . . I object to that. The question is irrelevant and immaterial and there is no issue in the case as to American Pipe and Steel Corporation being engaged in the real estate business. . . .

“The Witness. The answer is yes.”

H. The Edling incident is pointless.

Respondent seeks to inject a quality of mystery into the rather pointless testimony of Mr. Edling, a public accountant. (Brief, p. 16.) This testimony was merely that he was a member of an accounting firm which did work for petitioner (Tr. p. 571), that Exhibit T had his signature (Tr. p. 572), and that he did not remember anything about the incident (Tr. p. 573). The exhibit was a receipt given to one Roy W. Burton for some papers

of Palos Verdes. (Tr. p. 573.) The papers were not produced and it does not appear what they contained. The witness did not recall any reason for taking the papers unless somebody asked him to pick them up as a favor, and the only person he could think of was Mr. Lane. (Tr. p. 573.)

Of course, as respondent elsewhere admits (Brief, p. 29), petitioner had a legitimate interest in the affairs of Palos Verdes inasmuch as petitioner had agreed to loan funds to Archer for the purchase of the stock.

ARGUMENT.

I.

THE TAX COURT ERRONEOUSLY BASED ITS DECISION WHOLLY UPON AN ABSENT PRESUMPTION IN FAVOR OF RESPONDENT'S DETERMINATION.

A. The decision was expressly predicated upon the inapplicable presumption.

The Tax Court failed to make any findings of fact regarding petitioner's purpose in acquiring Palos Verdes. It relied, instead, wholly upon respondent's determination of deficiencies, as shown by the conclusion of both its "Findings of Fact" (Tr. p. 75: ". . . the evidence does not establish that respondent erred . . .") and of its "Opinion" (Tr. p. 79: ". . . it was petitioner's burden to prove that such determination was erroneous . . . we have concluded that petitioner has not successfully carried his burden of proof.').

As respondent concedes (Brief, p. 18), the Tax Court merely "affirmed the Commissioner's determination" as if it were a reviewing Court.

B. The Tax Court erred in relying upon the presumption.

The decision of the Tax Court is erroneous because it disregards the following principles: (1) The presumption in favor of the Commissioner's determination is merely a presumption of law affecting only the burden of proof; it is not an inference of fact nor does it have any probative force. (2) The effect of the presumption is merely to require the taxpayer to present a *prima facie* case contradicting the determination. (3) The presumption disappears when the taxpayer has introduced substantial evidence contrary thereto; thenceforth the issue depends wholly upon the evidence. (4) Upon the disappearance of the presumption, it became the duty of the Tax Court to decide for itself, from the evidence alone, whether or not petitioner's principal purpose in acquiring Palos Verdes was tax avoidance.

These principles are established by the decisions heretofore cited. (Op. Br., pp. 33-37.)

C. The Tax Court failed to give any consideration to the merits of the case independently of respondent's determination.

The Court's failure to consider the merits of the case is shown by the following points: (1) The fact that the conclusion was expressly predicated upon respondent's determination alone. (Tr. p. 75.) (2) The incomplete and disorganized recital of some evidence in the "Findings of Fact" without any attempt at analysis or evaluation of its relevance, importance or effect. (3) The failure to find any ultimate facts relating to the primary issues in the case. (4) The fact that the decision at the end of the "Opinion" was based solely upon respondent's determination. (Tr. p. 79.) And (5) the Court's failure

to discuss, analyze or list any reasons or grounds for its decision other than the fact that the Commissioner had made a determination adverse to petitioner.

D. Respondent has failed to meet this point.

The only decision cited by respondent on this point is *Hemphill Schools, Inc. v. Commissioner* (1943, 9th Cir.), 137 F.2d 961, which he seeks to distinguish upon the basis of a slight variation in language. (Resp. Brief, p. 38.) But this is plainly a distinction without a difference. If "the evidence does not establish that respondent erred" (Tr. p. 75), then the evidence necessarily "does not overcome the determination of respondent." (*Hemphill Schools, supra*, 137 F.2d at 963.) The one is the equivalent of the other. Moreover, here the Tax Court expressly based its decision on the theory that petitioner failed to prove that respondent's determination was erroneous. (Tr. p. 79.)

Respondent also contends that "the Tax Court's statement that the burden of proof was not carried is not the equivalent of saying that the presumption was not carried" and that petitioner's "burden was to overcome, not the presumption, but the volume of evidence which supported the Commissioner's position." (Brief, pp. 38-39.) These contentions are erroneous for three reasons:

First: The Tax Court did not hold that petitioner had failed to overcome any supposed "volume of evidence." It held only that petitioner had failed to overcome respondent's determination:

"The Commissioner having determined that the tax benefit to be gained was the principal purpose be-

hind that acquisition, *it was petitioner's burden to prove that such determination was erroneous*. After a careful study of the record made, we have concluded that petitioner has not successfully carried his burden of proof." (Tr. p. 79.) (Emphasis added.)

Second: There was no "volume of evidence which supported the Commissioner's position." The testimony of his four witnesses was cursory only and did not tend to rebut petitioner's case. (Tr. pp. 571-575, 575-585, 585-596, 621-633.)

Third: The statement that the petitioner failed to carry the burden of proving the Commissioner's determination erroneous is equivalent to saying that the presumption was not rebutted. (*Wiget v. Becker* (1936, 8th Cir.), 84 F.2d 706, 707, 708.) This is true because the taxpayer's burden in this respect is only to produce substantial evidence contrary to the determination. (*Hemphill Schools, supra*, 137 F.2d 961, 964.) The presumption disappears when evidence sufficient to support a contrary finding has been introduced (*Crude Oil Corp. v. Commissioner* (1947, 10th Cir.), 161 F.2d 809, 810) and thenceforth the issue depends wholly upon the evidence (*J. M. Perry & Co. v. Commissioner* (1941, 9th Cir.), 120 F.2d 123, 124.)

Finally, it is argued that the Tax Court need not analyze the record; that it is sufficient if its decision is supported by substantial evidence. (Resp. Brief, p. 39.) *Hemphill Schools* was first cited for this proposition and was then crossed out (Brief, p. 39) because that case decided just the opposite. The point is that, even if the Tax Court's decision were supported by substantial evi-

dence (and in this case it is not), the decision must nevertheless be reversed in a case, as here, where the Court has failed to consider the case on the merits after the presumption is dissolved.

II.

THE TAX COURT ERRONEOUSLY FAILED TO CONSIDER MATERIAL AND UNDISPUTED EVIDENCE COMPRISING A SUBSTANTIAL PART OF PETITIONER'S CASE.

The fact is that, upon the acquisition of Palos Verdes, petitioner utilized it in numerous ways as an effective and profitable subsidiary. (Op. Br., pp. 14-24.) And subsequent experience has demonstrated the good faith and sound business judgment of petitioner in acquiring the Palos Verdes lots. (Op. Br., pp. 24-25.) But none of these facts were considered or mentioned in the findings or opinion of the Tax Court. The "ultimate conclusion" of the Court was expressly based upon "the foregoing facts" (Tr. p. 75), that is, upon the pieces of evidence set forth in the findings.

Respondent's answer to this point is that, at the end of the "Opinion", the Tax Court referred to "a careful study of the record made." (Brief, p. 38.) But the Court merely referred back to its "ultimate conclusion" at the end of the findings; it stated that "we have concluded" and "We have accordingly so found." (Tr. p. 79.)

And if it is true, as respondent contends (Brief, p. 38), that "the decision was not based solely on the recited findings," then it must necessarily follow that the findings do not sustain the decision.

III.

THE FINDINGS OF THE TAX COURT DO NOT
SUPPORT ITS CONCLUSION.

The only point decided by the Tax Court was that petitioner had failed to produce any substantial evidence tending to overcome respondent's determination. (Tr. pp. 75, 79.) That decision does not find support even in the incomplete findings for these reasons: (1) The Court failed to find any ultimate facts which would sustain its conclusion. (2) The evidentiary findings made sustain the contrary conclusion.

Respondent seemingly concedes these points for he states that "the decision was not based solely on the recited findings." (Brief, p. 38.) It is also said that the question of petitioner's purpose in acquiring Palos Verdes was one of fact to be found by the trial judge. (Brief, p. 23.) If this be true, then our position must be sustained, for no finding was made on that issue.

Respondent makes various other contentions as to what he thinks *could* be found, but, assuming the validity of his contentions, the fact remains that no such findings were made. It is contended, for example, that Archer was an agent of petitioner so that all his activities were in reality attributable to petitioner. (Brief, p. 27.) Even if this argument amounted to anything but a smear attempt, the fact is that it is contrary to the undisputed evidence and it is also contradicted by the findings. It was found that *Archer* was interested in the possibilities of profit to be made on the Palos Verdes lots, that petitioner agreed to *lend* money to Archer for his acquisition of the stock, that the stock escrow account was opened

by Archer individually, and that “some 2,500 shares of Palos Verdes stock *were obtained by Archer* through the escrow procedure.” (Tr. pp. 56-57.)

Other arguments of respondent are that on December 2, 1943, petitioner’s financial outlook was bright (it had no war contracts and was facing a huge loss), that no loss on the chemical warefare contract could have been anticipated (a loss of up to \$600,000 *was* anticipated), and that the Tax Court could infer that petitioner would quickly obtain additional defense contracts (petitioner had no other large contracts and did not obtain any until the latter part of 1944). (Brief, pp. 33, 31, 32.) All such arguments are advanced in the face of undisputed evidence to the contrary and none of them finds any support in the findings.

In no instance has respondent pointed to any finding of any ultimate facts or of any facts which would lead to, or provide support for, the decision of the Tax Court. The evidentiary findings, although incomplete, support the contrary conclusion.

IV.

THE DECISION OF THE TAX COURT IS NOT SUPPORTED BY THE EVIDENCE.

- A. Petitioner affirmatively established that it did not acquire Palos Verdes for the principal purpose of avoiding taxes.

As we have shown (Op. Br., pp. 7-24), pursuant to the program presented by its president in his November 25th letter, petitioner acquired Palos Verdes for the purpose of utilizing it as an effective and profitable sub-

subsidiary to further the business interests of petitioner, and the subsidiary was actually so used. The sound business judgment exercised by petitioner in making such acquisition has been demonstrated by subsequent experience; the tremendous potentialities of the Palos Verdes lots has been proved. (Op. Br., pp. 24-25.)

Petitioner further proved that it had neither motive nor reason for attempting to find means of reducing income or excess profits taxes, and it did not do so. (Op. Br., pp. 26-28.) Petitioner was a small company without any history or prospects of large profits or high earning assets. Its sole war contract of any substance had been cancelled some two months prior to the acquisition of Palos Verdes and, thereupon, petitioner was faced with a huge loss. It had never received any other large contracts. Petitioner's total backlog of prime contracts on December 31, 1943, amounted to only \$850. It was not awarded any further war contracts of any size until the latter part of 1944. The fact is that petitioner was seeking profits possibilities and not tax reduction.

Petitioner's situation and acquisition did not come within the purpose, objective or intent of Section 129 of the Internal Revenue Code and that section is inapplicable. Respondent's discussion of Section 129 (Brief, pp. 21-23) omits all reference to the basic objective of the statute, that is, to discourage the practice of corporations *with large excess profits* from buying up tax loss companies. As stated in *Commodores Point Terminal Corp.* (1948), 11 T.C. 411, 415-416:

"The report of the Senate Committee on Finance stated that the objective of the section was 'to prevent the distortion through tax avoidance of the de-

duction, credit, or allowance provision of the code, particularly those of the type represented by the recently developed practice of corporations *with large excess profits* (or the interests controlling such corporations) acquiring corporations with current, past, or prospective losses or deductions, deficits, or current or unused excess profits credits, for the purpose of reducing income and excess profits taxes. . . .” (Emphasis added.)

The same objective is recognized in the Regulations (26 CFR 39.192-3):

“(b) If the requisite acquisition and purpose exist, among the transactions within clause (1) of section 129(a) are the following:

“(1) A corporation (or the interest controlling such a corporation) *with large profits* acquires control of another corporation . . .

“(2) A corporation *with large profits* transfers the assets of each of its branches . . .

“(3) A corporation *with high earning assets* transfers them to a newly organized subsidiary . . .” (Emphasis added.)

It is indisputable that Section 129 was never intended to apply to an acquisition by a small company, such as petitioner, with a history of losses or small profits, with no immediate prospects of anything except further losses, and without any “high earning assets.” Nor can the requisite purpose of tax avoidance be found in such a situation in the absence of any evidence thereof.

Respondent also asserts that the question of purpose “is one of fact for the trial judge.” (Brief, p. 23.) The answers to this assertion are threefold:

First: The Tax Court did not undertake to find what petitioner's purpose was in acquiring its subsidiary. It merely "affirmed the Commissioner's determination." (Resp. Brief, p. 18.) Such evidentiary facts as were actually found support the contrary conclusion, that is, that the acquisition was not for tax avoidance. Thus, the Tax Court found that on November 25, 1943, Mr. Lane wrote a letter to the board of directors of petitioner outlining the business purposes for which Palos Verdes was to be used, and the authenticity and sincerity of the letter were not questioned. (Tr. pp. 67-72.)

Second: There was no basis for any finding (and none was made) that petitioner's principal purpose in making the acquisition was tax avoidance. Petitioner affirmatively established that business purposes motivated the acquisition and that it had no motive for avoiding taxes.

Third: Where, as here, it is the duty of the Court to draw from the facts an ultimate inference of purpose or intention and not to deal with a technical tax question, the Court of Appeals is as well equipped as the Tax Court and "for that reason the Tax Court decision calls for little more weight than its logic suggests." (*Gillette's Estate v. Commissioner* (1950, 9th Cir.), 182 F.2d 1010, 1015.) The only "logic" applied by the Tax Court was this (Tr. p. 79):

"In the instant case, petitioners do not and cannot deny that American Pipe acquired control of the corporate property of Palos Verdes, subsequent to the specified date, nor that, as an incident thereof, it stood to enjoy tax benefits not otherwise available to it. As above observed, petitioner denies, however, that the tax benefits were the principal consideration or motivating purpose behind the acquisition."

This is the same type of "logic" characterized as "faulty reasoning" in *Gillette's Estate*, *supra*, 182 F.2d 1010, 1015. The mere fact that petitioner ultimately gained a tax benefit does not show that its principal purpose was tax avoidance. Moreover, it is simply not true that petitioner necessarily stood to enjoy tax benefits by the acquisition. The fact is that, on the date of acquisition, petitioner was still negotiating with respect to the termination of the chemical warfare contract, and it appeared likely that petitioner would have no income at all in 1943. The final settlement on that contract resulted in a loss which practically wiped out petitioner's income for the year. Petitioner's backlog of \$850 in war contracts on December 31, 1943, certainly did not foreshadow much in the way of 1944 income, nor did the first six months of 1944. And if petitioner had been able to carry out its plans for Palos Verdes completely, the probability of paying additional income taxes was far from remote.

B. The presumption in favor of respondent's ruling has no probative force.

Petitioner having presented substantial evidence contrary to respondent's determination, the decision of the Tax Court could not be rested in whole or in part on that determination. (Decisions cited in our opening brief, pp. 48-49.)

C. The Tax Court could not disregard petitioner's undisputed evidence.

It was shown without contradiction that petitioner's business purposes in acquiring Palos Verdes were as set forth in Mr. Lane's letter of November 25, 1943 and that petitioner actually utilized Palos Verdes to carry out those

purposes so far as possible. It was established, further, that petitioner's inability to carry out the program completely was due to the peculiar redemption period provided in the interlocutory decree in the Palos Verdes tax suit, that such provisions were not known to petitioner at the time of the acquisition, that petitioner did not have the funds to pay the property taxes in a lump sum in the short period of time available, and that the County Assessor ruled that the taxes could not be paid in installments because of the unusual provisions of the decree. (Tr. pp. 405, 406, 453, 492-493.)

The business purposes of petitioner, therefore, were shown both by the direct and positive documentary evidence and also by the direct, positive and unimpeached testimony of petitioner's president. Under these circumstances, the Tax Court could not arbitrarily disregard petitioner's evidence.

(Foran v. Commissioner (1945, 5th Cir.), 165 F.2d 705, 707;

Wright-Bernet v. Commissioner (1949, 6th Cir.), 172 F.2d 343, 346;

Crude Oil Corp. v. Commissioner, supra, 161 F.2d 809, 810;

R. P. Farnsworth & Co. v. Commissioner (1953, 5th Cir.), 203 F.2d 490, 492.)

In order to sustain respondent's position, it would be necessary to hold not only that petitioner's uncontradicted evidence was wholly false, but that it also tended to prove *just the opposite*, particularly:

1. That the entire testimony of Mr. Lane as to the purposes for which and the means by which Palos Verdes

was acquired, and the purposes for which it was utilized, was not only entirely false, but that it tended to prove just the opposite—tax avoidance;

2. That Mr. Lane's letter of November 25th, setting forth the reasons why the acquisition would be beneficial to the business of petitioner, was not only false, but tended to prove just the opposite of its contents;

3. That the meeting and action of petitioner's board of directors on November 26th, including the resolution then adopted, was not only false, but also tended to prove just the opposite;

4. That Mr. Lane's computations and notes of December 2, 1943, in which he worked out the profit possibilities on the Palos Verdes lots, was not only false, but further tended to show quite the opposite;

5. That petitioner's development and use of Palos Verdes as a profitable subsidiary not only failed to show business purpose, but tended to show just the reverse—tax avoidance;

6. That the uncontradicted testimony of Archer, Lane and Towles as to the values of the Palos Verdes properties was not only false, but tended to show that they were worthless;

7. That the undisputed evidence as to petitioner's small profits and losses in the past, as to its loss on the chemical warfare contract, as to its small profit in 1943, and as to its \$850 backlog of war contracts on December 31, 1943, was not only false, but tended to show that petitioner had large past, present and prospective profits;

8. That the note from Mr. Lane to Kreiger of July 29, 1942 (Ex. 19; Tr. p. 349), stating the terms on which

Archer would come to work for petitioner, was not only false, but tended to prove that Archer became employed by petitioner for other reasons;

9. And that Archer's letter of May 25, 1943, to petitioner, whereby Archer attempted unsuccessfully to interest petitioner in investing in the Palos Verdes project (Ex. 6; Tr. pp. 161-162), was not only false, but had the effect of showing that petitioner was already acquiring Palos Verdes stock.

The vice of this type of reasoning was pointed out in *United States v. American Bell Telephone Co.* (1896), 167 U.S. 224, 259, 42 L.Ed. 144, 160-161, 17 S.Ct. 809:

"The difficulty with this charge of wrong is that it is not proved. It assumes the existence of a knowledge which no one had; of an intention which is not shown. It treats every written communication from the solicitor in charge of the application, calling for action, as a pretence, and all the oral and urgent appeals for promptness as in fact mere invitation to delay. It not only rejects the testimony which is given, both oral and written, as false, but asks that it be held to prove just the reverse."

V.

RESPONDENT CANNOT SUSTAIN THE DECISION ON OTHER GROUNDS.

Seeking to abandon completely the position assumed in his deficiency notice and in the Tax Court by now adopting some vague theory of "real economic loss," respondent argues that petitioner was not entitled to file consolidated tax returns regardless of Section 129 of the Internal Revenue Code. This theory is based upon the same fac-

tual distortions exposed above, that is, that petitioner “paid a premium for the stock of an unsuccessful, financially distressed corporation . . . in an attempt to offset the losses of the latter against its own profits and thereby avoid taxation” and that the real loss “was felt by the old stockholders of Palos Verdes who held the stock as the land declined in value to almost worthlessness.” (Brief, pp. 39, 41.)

This argument is unsound for these reasons:

1. Neither the deficiency notice nor the decision below was based on any such theory. The deficiency notice was made on the ground that petitioner acquired Palos Verdes for the principal purpose of avoiding taxes, that, therefore, Palos Verdes was not a member of an affiliated group of corporations within the intent of Section 141 of the Internal Revenue Code and that the privilege of filing consolidated returns was not within “the purview” of Section 141. (Tr. pp. 30-31.) No claim was made that the consolidated returns were or could be disallowed under Section 45 or on any other ground. Moreover, petitioner’s position in the Tax Court (Tr. pp. 110-111) and the decision therein (Tr. pp. 75-79) were both predicated solely upon the alleged applicability of Section 129, and respondent cannot sustain the decision on any other ground. (*Commissioner v. Chelsea Products, Inc.* (1952, 3rd Cir.), 197 F.2d 620, 624.)

2. As shown, petitioner did not pay a “premium” for the stock.

3. While Palos Verdes was in financial difficulty, its lands were far from worthless. The lots had values far in excess of the taxes assessed on them, and such values have been proved.

4. Petitioner did not acquire Palos Verdes for tax avoidance purposes, but for business reasons. At the time of acquisition, petitioner had no record of large past profits, it had but slight prospects of any profits in 1943, and it had no backlog of war contracts or other reason to anticipate future profits of any size. That petitioner would gain any tax advantage of any consequence could not have been foreseen.

5. There was nothing "fabricated" about the Palos Verdes losses. Respondent abandoned all dispute regarding the reality and amounts of such losses.

6. Such losses were sustained by Palos Verdes itself, there was no showing of any loss by any Palos Verdes' stockholder, and the losses were properly reported by Palos Verdes on its tax returns. Section 45 of the Internal Revenue Code is inapplicable. There is no problem of allocation of income or deductions between or among corporations. No question is raised as to any arbitrary or improper shifting of income or deductions from one corporation to another. (*Simon J. Murphy Co. v. Commissioner* (1956, 6th Cir.), 231 F.2d 639, 644.) The Commissioner cannot act under Section 45 where the income of the corporations is properly reflected on their respective books of account. (7 Mertens, Law of Federal Taxation, sec. 38.63, pp. 124-125.)

7. The decisions cited by respondent do not sustain his position. The decision in *Woolford Realty Co. v. Rose* (1931), 286 U.S. 319, 76 L.Ed. 1128, was not based upon any grounds of tax avoidance, but was made entirely on a strict construction of the statutory provisions regarding loss carry overs. (See comment, Barnard, Acquisitions

for Tax Benefit, 34 Cal.L.Rev. 36, 41-42.) Moreover, the subsidiary's loss during the year of its acquisition was allowed; carry overs of past losses only were disallowed.

Similarly, in *Ericsson Screw Machine Products Co.* (1950), 14 T.C. 757, it was held that a transactions was a sale of assets rather than a reorganization because it did not come within the terms or purposes of the statutory provisions concerning reorganizations.

In *J. D. & A. B. Spreckels Co.* (1940), 41 B.T.A. 370, the taxpayer acquired the stock of the subsidiary for \$1. There was no business purpose whatever for the acquisition, since the subsidiary was insolvent, it was not engaged in business, it had contracted to sell all its assets, there was nothing to show any intention of resuming business, and the subsidiary was subsequently dissolved. The soundness of the decision may be doubted (see, Barnard, Acquisitions for Tax Benefit, 34 Cal.L.Rev. 36, 43-44), but it does not assist respondent in any event. The decision was only that, in the absence of Section 129, a tax benefit could be disallowed only if tax avoidance was the *sole* purpose of the acquisition (this was respondent's position in the Tax Court here: Tr. pp. 110-111); hence, if the present case cannot be sustained under Section 129 (requiring only that the *principal* purpose be tax avoidance), then it certainly cannot be sustained under the *Spreckels* case.

8. Finally, the mere fact that a transaction eventually results in tax consequences unfavorable to the Government does not authorize respondent's determination. (See, *Simon J. Murphy Co. v. Commissioner*, *supra*, 231 F.2d 639, 645.) This Court cannot legislate disallowance of such tax benefits; it can only act judicially.

CONCLUSION.

It is respectfully submitted that respondent has failed to overcome any of the points raised in our opening brief. Here, as in the Tax Court, respondent seeks only to smear petitioner by the artful use of wholly unconnected matters, aided by the tortuous twisting of the facts to fit what is supposed to be a pattern of vaguely sinister events. We submit that no sincere effort has been made to show that the Tax Court's decision is justified by the findings or the evidence. The decision should be reversed for each of the reasons stated.

Dated, San Francisco, California,
December 28, 1956.

Respectfully submitted,

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